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IN THE

Supreme Court of the United States

October Term, 1964

No. 140

ISADORE BLAU,

Petitioner,

vs.

DAVIS FACTOR; LOUIS FACTOR; MAX FACTOR, JR.; SIDNEY FACTOR; CHESTER FIRESTEIN; MAX FIRESTEIN; FREDA F. SHORE; ANNA FACTOR; DORIS FACTOR; DOROTHY FACTOR; CECILIA FIRESTEIN, and MAX FACTOR & CO.,

Respondents.

PETITION FOR WRIT OF CERTIORARI.

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1 Fletcher, Cyclopedia of Corporations, Sec. 5086, p. 56 5

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PETITION FOR WRIT OF CERTIORARI.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner, Isadore Blau, a stockholder of Max Factor & Co., respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, rendered February 24, 1965 [R. 152, *infra*, App. p. 3], which affirmed the judgment of the United States District Court for the Southern District of California, Central Division [R. 143], dismissing the complaints and cross-complaint against the individual respondents herein.

Opinions Below.

The District Court did not render any opinion in the actions. Its Findings of Fact and Conclusions of Law [R. 137] were not officially reported. The opinion of the Court of Appeals [R. 152, App. p. 1] has not yet been reported.

Jurisdiction.

The judgment of the Court of Appeals [R. 152, App. p. 1] was entered on February 24, 1965.

Jurisdiction is conferred upon this Court by 28 U.S.C., Section 1254(1).

Question Presented for Review.

Where insiders of a listed corporation, owning more than a majority of its voting stock and constituting more than a majority of its Board of Directors and Officers, *voluntarily* convert their *long-term investment* in the corporation's *unlisted* shares of stock into *listed, dividend preferred* shares which are then sold by them at a profit within less than six months,—are such acquisitions of the listed, dividend preferred shares "purchases" within the meaning and purpose of Sections 16(b) and 3(a)(13) of the Securities Exchange Act of 1934, 15 U.S.C.A., Secs. 78p(b) and 78c(a)(13)?

Statutes and Regulations Involved.

Pertinent provisions of the Securities Exchange Act of 1934, Sections 16(a),16(b) and 3(a)(13), 15 U.S.C.A., Sec. 78p(a), p. 46 Cum. Sup., Sec. 78p(b), p. 322, and Sec. 78c(a)(13), p. 235, are set forth in the Appendix, *infra*, p. 1.

Statement of Facts.

The action was brought by petitioner, Blau, as a stockholder of Max Factor & Co., (hereinafter referred to as the "Issuer"), pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sec. 78p(b), to recover the short-swing profits realized by the individual respondents from their respective purchases and sales of the Issuer's listed securities within periods of less than six months.

The basis for jurisdiction of the United States District Court for the Southern District of California is Section 27 of the Securities Exchange Act of 1934, 15 U.S.C.A., Sec. 78aa.

Each of the individual respondents is related to the others by blood or marriage, and, together with other members of their families, Trusts and a Foundation controlled by them, own or control approximately 75% of the Issuer's voting stock, and constitute more than a majority of its Board of Directors, officers and members of its Executive Committee [R. 29, 32, 118].

During all the material times here involved each of the individual respondents was a director, officer or beneficial owner of more than 10% of the Issuer's listed securities [R. 29, 32, 118].

The Issuer's capital stock is divided into two separate and definitive classes, designated as "Common Stock" and "Class A Stock," respectively [R. 80, Ex. A, p. 3].

The individual respondents herein, together with the members of their families and various Trusts and a Foundation controlled by them, have at all time since 1947 owned substantially all of the Issuer's outstanding shares of Common Stock [R. 105, 119].

The Common Stock has never been listed upon any national securities Exchange and has never been registered nor exempted from registration under the Securities Act of 1933 [R. 116, 117].

The shares of the Issuer's Class A Stock, on the other hand, were listed on The American Stock Exchange until April 18, 1961, and have been listed since that date on the New York Stock Exchange, and have been actively traded by the general public [R. 116].

The powers, rights and preferences of each of the aforesaid classes of stock are set forth in the Issuer's Certificate of Incorporation, and are substantially as follows [R. 80, Ex. A, p. 3].

(a) Each Class is entitled to one vote per share, and voting is not by separate classes "except where specifically so required by law."

(b) The right to the payment of dividends is not cumulative with respect to either Class, but the holders of the *Class A Stock* are entitled to dividends "in preference and priority to any payment of any dividend on Common Stock." Moreover, it is only *"after* a dividend * * * has been so paid or declared and set apart for payment on the *Class A Stock,"* that a dividend "equal to or less than such dividend" may be declared and paid on the shares of Common Stock. The cash dividends paid upon the shares of *Class A Stock* have always been substantially greater than the dividends paid on the shares of Common Stock [R. 115].

(c) Although the unlisted shares of Common Stock were convertible at the holder's option into listed Class A Stock on a share for share basis, the Issuer's Board of Directors was authorized to adopt a resolution at any

time *requiring* "that the Class A Stock be exchanged share for share for Common Stock." This latter provision, coupled with its right to a dividend preference, clothed the Issuer's *Class A Shares* with all the attributes of a "Callable Preferred" Stock.*

Sometime during December, 1960, initial conferences were held between the representatives of certain underwriters and the individual respondents herein regarding the latter's sale to the public of 200,000 shares of the Issuer's *Class A Stock*. The agreement ultimately reached provided that the initial offering price of such shares would be fixed and determined by mutual agreement "not higher than the last reported sales price (regular way) * * * on The American Stock Exchange immediately prior to such determination." Such offering price of the Class A Stock was finally fixed at $56.75 per share [R. 121].

In order to be in a position to sell the Issuer's *Class A Stock* pursuant to their contemplated public offering thereof, the individual respondents *voluntarily* converted 200,000 shares of their *Common Stock* into a like number of *Class A* shares on March 14, 1961. The price on that date of the *Class A Stock* ranged between $41-$44 7/8 per share [R. 119].

Approximately one month thereafter, on April 18, 1961, the individual respondents sold the 200,000 shares of Class A Stock, receiving the net sum of $53.80 per share therefor [R. 106].

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*"Corporations sometimes issue different classes of so-called 'common stock', often called Class A and Class B. * * * If the distinction between the classes * * * is not in voting rights but in priority or amount of participation in earnings or assets, the class that has priority is really a participating preferred stock as against the other class." *Fletcher, Cyclopedia of Corporations*, Sec. 5086, p. 56 (Perm. Ed. 1958, Rev. Vol. 1).

During the first quarter of 1961, the individual respondents herein, constituting a majority of the Issuer's Board of Directors, caused the Issuer to declare the regular 20¢ cash dividend on its shares of Class A Stock *plus an extra 4% stock dividend thereon* [R. 115].

During the one month period, between which the individual respondents converted their Common Stock and sold the Class A shares acquired thereby, the prices at which the Class A shares were traded on The American Stock Exchange skyrocketed from $41 to $61 per share, a spread of 20 points or 49%. In fact, at the end of this one month period, its market price was approximately $18 per share *higher* than at the beginning, an *increase* of 41.5% [R. 131-133].

In contrast to such an extraordinary price pattern, and during the same one month period, the market prices of the shares of four other companies, engaged in the same business as the Issuer, similarly listed on The American Stock Exchange, having market ratings equally as good or better than the Issuer's Class A Stock and selling within a similar price range, showed a spread of between 5 to 8 1/2 points per share, or only 9%-19.4%. Moreover, at the end of this one month period the market prices of the shares of each of these four comparable companies actually *decreased* between 2%-4% from their initial price range at the beginning of such period [R. 131-133].

The District court granted the individual respondents' motions for summary judgment and dismissed the complaint without opinion. In its findings, that court held that, (a) the individual respondents' acquisitions of the Issuer's shares of Class A Stock by converting their

Common Stock therefor "do not constitute 'purchases' within the purpose and meaning of Section 16(b) of the Securities Exchange Act of 1934", and (b) the individual respondents "did not, within the purpose and meaning of Section 16(b) * * * 'realize' any profit from any 'purchase and sale' * * * by reason of the exchanges by them of Common Shares for Class A Shares, followed by the sale of Class A Shares" within less than six months.

The Court of Appeals affirmed.

Reasons for Granting the Writ.

1. The Court of Appeals for the Ninth Circuit has decided an important question of federal law which has not been, but should be settled by this Court. The interpretation of the federal statute by the Court of Appeals finds no sanction in the statute and is in conflict with the stated Congressional purpose and intent which prompted its enactment.

2. The decision by the Court of Appeals for the Ninth Circuit, that an insider's conversion of his *long-term investment* in an Issuer's shares does not constitute a "purchase" of shares *acquired* thereby, conflicts with the decisions in *Park & Tilford, Inc. v. Schulte* (2 C.A.), 160 F. 2d 984, *B. T. Babbitt, Inc. v. Lachner* (2 C.A.), 332 F. 2d 255, and *Booth v. Varian Associates, Inc.* (1 C.A.), 334 F. 2d 1.

ARGUMENT.

I.

The Court Below Has Decided an Important Question of Federal Law Which Has Not Been, but Should Be, Settled by This Court.

The stated congressional purpose for enacting Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sec. 78p(b), was

> "preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer by reason of his relationship to the issuer."

In enumerating its reasons for enacting such legislation and stating the evils sought to be corrected thereby, Congress pointed out the imperative need to regulate and control "transactions by officers, directors and principal security holders * * * to insure the maintenance of fair and honest markets in such transactions" because "frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control * * * resulting in sudden and unreasonable fluctuations in the prices."[1]

In seeking to discourage such activities, "congress sought to take the profit out of what it considered improper conduct"[2] by requiring insiders of listed corporations to disgorge any profits realized from their purchases and sales of its securities within any period of less than six months. Although this statutory deterrent against insider trading initially encompassed only those issuers whose securities were listed upon a

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[1]Section 2, Securities Exchange Act of 1934, 15 U.S.C.A., Sec. 78(b).

[2]*Adler v. Klawans* (2 C.A.), 267 F. 2d 840, 844.

national securities exchange, such limited protection was found to be so vitally important to the general body of public investors that Congress recently extended its applicability to certain issuers having no securities listed upon any national exchanges.[3]

In order more fully to accomplish the legislative purpose against such insider-trading, Congress expressly *broadened* the ordinary definition of "purchase" so that it would include "*any contract* to buy, purchase, *or otherwise* acquire",[4] thus evidencing its intention that "purchase" and "acquisition" be used interchangeably.

Since the individual respondents' ownership of their Issuer's unlisted Common stock carried with it an option to convert such shares into the listed Class A Stock, this conversion option was in fact a "contract to * * * otherwise acquire" the latter shares, and thus fell squarely within the statutory definition of "purchase".

Moreover, an insider's short-swing trading on the basis of options was one of the primary evils against which Section 16(b) of the Act was aimed. Congressional investigations clearly disclosed that "many of the most flagrant abuses upon stock exchanges would not be possible without the aid of options", and that "they are indispensable concomitants of every pool operation designed to distribute stock at an increased price".[5] The insider's use of options "has been found

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[3]Sections 12(g) and 16(a), Securities Exchange Act of 1934, as amended in 1964; 15 U.S.C.A. Secs. 78-1(g) and 78p(a), as amended in 1964.

[4]Section 3(a)(13), Securities Exchange Act of 1934, 15 U.S.C.A., Sec. 78c(a)(13).

[5]Senate Report No. 792 on Federal Securities Exchange Act of 1934 (1934), 73d Cong., 2nd Sess., p. 9.

to be at the bottom of most manipulative operations" because it "permits large-scale manipulations to be conducted with a minimum of financial risk", and, "as it is not always easy to trace and prove manipulative activity, it is necessary to rid the market of devices which commonly accompany or cloak these activities."[6]

In view of such unequivocal evidence of Congressional intent against an insider's use of options, conversions and similar devices as an aid to his short-swing transactions in his issuer's securities, "and in order to give maximum support to the statute, courts have attempted to include these transactions by characterizing them as purchases or sales", and "this has led to inconsistent results in the decisions, * * * and conflicting views among the commentators."[7]

In attempting to formulate a yardstick in determining whether an insider's conversion of his issuer's stock constitutes a "purchase" of the shares acquired thereby within the purpose and intent of Section 16(b), the courts have applied the standard that a "transaction is a 'purchase' if *in any way* it lends itself to the accomplishment of what the statute is designed to prevent",[8] or, if it "can *possibly* lend itself to the speculation encompassed by Section 16(b)."[9]

Although the application of such legal standards to the facts of this case demanded a determination by the Court of Appeals that the individual respondents' vol-

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[6]House of Representatives Report No. 1383 (1934) on Securities Exchange Bill of 1934, p. 10.

[7]*Booth v. Varian Associates, Inc.* (1 C.A.), 334 F. 2d 1, 4.

[8]*Blau v. Lehman* (2 C.A.), 286 F. 2d 786, 792, aff'd 368 U.S. 403.

[9]*Ferraiolo v. Newman* (6 C.A.), 259 F. 2d 342, 344-345.

untary conversions of their Issuer's unlisted Common Stock constituted "purchases" of the listed Class A shares acquired thereby, the Court refused to do so. The basis of its decision was predicated upon the fact that, since the individual respondents had owned the Issuer's unlisted Common Stock for many years, their conversions of such stock "conferred no opportunity for speculative profits which the appellees did not already enjoy", and they "made only one investment decision in the six months' period — the decision to terminate their *long-term investment* by sale, * * * in reality only a step in the process of sale." (App. p. 9)

The impact of this decision, if it is permitted to stand, will have a serious repercussion upon the effectiveness of Section 16(b) of the Act and will open the door to successful evasion of its salutary provisions in the very area which Congress thought was in most need of regulation.

For, under the rationale of the decision below, every acquisition of an issuer's security by an insider through his exercise of an option or conversion of stock would automatically be excluded from the operation of the statute where the insider has owned such option or convertible security for more than six months. The possession of a backlog of such "long-term" options or convertible securities would thus enable the insider to engage in short-swing transactions and use his inside information with impunity, completely immunizing him against the statutory liability for his profits.

II.

The Decision Conflicts With the Decisions by the Courts of Appeals of Other Circuits.

The decision by the Court of Appeals, that a controlling insider's voluntary conversion of his "long-term investment" in his issuer's Common Stock does not constitute a "purchase" under Section 16(b) of the dividend-preferred shares acquired by him thereby, conflicts with the decisions on the same point by the Courts of Appeals for the First and Second Circuits.

In *Park & Tilford, Inc. v. Schulte* (2 C.A.), 160 F. 2d 984, *B. T. Babbitt, Inc. v. Lachner* (2 C.A.), 332 F. 2d 255, and *Booth v. Varian Associates, Inc.* (1 C.A.), 334 F. 2d 1, the Courts of Appeals held in each of such cases that an insider's conversion of his issuer preferred stock into common stock constituted a "purchase" of the latter shares acquired thereby within the purpose and meaning of Section 16(b), although the preferred stock had been owned by the insider for several years prior to its conversion. Moreover, in each of these cases, the insider raised and thoroughly argued the point of his "long-term investment" of his preferred stock, but the Courts refused to sustain such argument.

In view of such conflicting opinions, this important area of the law now becomes almost ludicrously uncertain. Unless such uncertainty is settled by this Court, the administration and enforcement of the statute will be diluted to such an extent that its continued existence will become meaningless.

Conclusion.

For the foregoing reasons, this petition for a writ of Certiorari should be granted.

Respectfully submitted,

KENNY, MORRIS & IBANEZ, and
MORRIS J. LEVY,
Counsel for Petitioner, Blau.

APPENDIX.

Statutes.

Sections 16(a) and Section (b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sects. 78p(a) and 78p(b), provide as follows:

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78 (g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such months, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by rea-

son of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78c(a)(13), provides as follows:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Isadore Blau, Appellant, vs. Max Factor & Company, et al., Appellees. No. 19,202.

[Feb. 24, 1965]

Appeal from the United States District Court for the Southern District of California, Central Division.

Before: Barnes, Hamley, and Browning, Circuit Judges.

Browning, Circuit Judge:

Appellant, a stockholder of Max Factor & Co., brought this action under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78p(b),[1] to

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[1]Sec. 16(b) reads:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer . . . in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or

recover, on behalf of the corporation, profits said to have been realized by corporate insiders in a short-swing speculation in the company's Class A stock. The district court granted appellees' motion for summary judgment. We affirm.

Prior to 1947 Max Factor & Co. was a family corporation. In that year Max Factor Common stock was offered to the public. Class A stock was issued in the following year. It was created as a part of a plan to permit the company to pay maximum dividends to non-family stockholders while retaining earnings otherwise payable to the family stockholders (the appellees) for use in the business, without exposing the family stockholders to potential tax liability.

The Class A thus created had equal voting powers with the Common, rights on liquidation were the same, neither class was subject to redemption, and both were fully transferable. However, the board of directors was empowered to declare lesser dividends on Common than were declared on Class A.[2] Common was made ex-

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any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Sec. 16(b) applies to the same persons as § 16(a), that is, "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security . . ."

For the purpose of their motion for summary judgment, appellees concede that they are members of the class to which § 16-(b) applies.

[2]At all relevant times appellees owned more than 75% of the voting stock, and constituted more than a majority of the board of directors. They were therefore able to determine whether and to what extent the power to declare lesser dividends on their Common would be exercised. Dividends declared on Common were in fact materially below those paid on Class A.

changeable for Class A at any time, and, as had been planned, substantially all of the public stocholders immediately exchanged their Common for Class A, while the appellees retained their Common.

Late in 1960 appellees decided to offer a portion of their stock interest to the public. On March 14, 1961, in contemplation of this public sale and in exercise of the right conferred by the company's certificate of incorporation, they exchanged 200,000 shares of their Common for an equal number of shares of Class A. They sold the latter to the public on April 18, 1961.

The Common involved in the exchange had been acquired by appellees from five to thirty-two years earlier. No appellee acquired Class A within six months of the sale, except by the exchange. This suit was brought to recover the "profit" which resulted from an increase in the market price of Class A during the month between the exchange and sale.

Concededly appellees are corporate insiders of Max Factor & Co., subject to section 16(b). Concededly they made a "sale" of Class A less than six months after acquiring the Class A in exchange for Common. However, the district court concluded that the exchange of Common for Class A was not a "purchase" of the Class A within the meaning of section 16(b). We agree.[3]

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[3]The district court also held that the transaction was excluded from § 16(b) by Securities Exchange Commission Rule 16B-9, issued by the Commission some four months after the filing of this action. Rule 16B-9 purports to exempt from the operation of § 16(b) the exchange of shares of one class of stock for shares of another of the same corporation, pursuant to a right of conversion granted by the company's charter, if (1) the classes of shares exchanged evidence substantially the same rights and privileges except that the board of directors may declare a lesser

The statutory definitions of "purchase" and "sale" are exceedingly general.[4] They are given specificity by measuring questioned transactions against the purpose of section 16(b). Thus, a transaction is held to be a "purchase" within section 16(b) "if in any way it lends itself to the accomplishment of what the statute is designed to prevent." *Blau v. Lehman*, 286 F.2d 786, 792 (2d Cir. 1960), aff'd 368 U.S. 403 (1962). See also *Park & Tilford v. Schulte*, 160 F.2d 984 (2d Cir. 1947). On the other hand, to avoid purposeless harshness, a transaction is held not to be a section 16(b) "purchase" if it "was not one that could have lent itself to the practices which Section 16(b) was enacted to prevent." *Ferraiolo v. Newman*, 259 F.2d 342, 346 (6th Cir. 1958). See also *Roberts v. Eaton*, 212 F.2d 82, 85-86 (2d Cir. 1954); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir. 1949). *Cf. Blau v. Mission Corp.*, 212 F.2d 77, 80 (2d Cir. 1954) ("sale"); *Falco v. Donner Foundation*, 208 F.2d 600, 604 (2d Cir. 1953).[5]

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dividend on the class surrendered than on that acquired; and (2) the exchange was effected in contemplation of a public sale of the shares acquired. The rule was expressly made retroactive. 17 C.F.R. § 240-16b-9 (1963).

Since we decide that § 16(b) was in any event inapplicable, we do not consider the applicability and validity of Rule 16B-9.

[4]Sec. 3(a)(13), 15 U.S.C.A. § 78c(a)(13) provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

Sec. 3(a)(14), 15 U.S.C.A. § 78c(a)(14) provides: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

[5]It has been suggested that as to conversions the statute should be applied broadly, "leaving it to the Securities and Exchange Commission to make appropriate exemption for transactions which fall within the letter of the statute but not its spirit." Meeker & Cooney, 45 Va.L.Rev. 949, 964-65 (1959). However, the primary duty of administering § 16(b), unlike other provisions of the Act, is not imposed upon the Commission, but upon the courts through the medium of stockholder suits. Moreover, the

The initial inquiry must therefore be: What is the purpose of section 16(b)—what practices is the statute designed to prevent?

As section 16(b) itself states, its general purpose is to preclude the "unfair use of information which may have been obtained by" corporate insiders, in trading in the securities of their corporation. But Congress did not seek to accomplish the whole of this purpose by section 16(b) alone. Section 16(b) creates a special remedy, applicable only in a limited situation. Absolute liability is imposed,[6] but only when the insider both acquires and disposes of securities of his corporation "within any period of less than six months." When acquisition and disposition are separated by a longer period, section 16(b) is inapplicable; other remedies are then available, but only upon proof of actual wrongdoing.[7]

The fact that section 16(b) was intended to apply only to insider "short-term speculative swings" is con-

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Commission has been slow to exercise its power of exemption. In these circumstances, whether § 16(b) is to have a flexible or mechanistic application in practice must depend upon the courts.

[6]The insider is required to relinquish his profits, even though he did not enter into the stock transactions with the intention of speculating, and did not utilize, or even possess, confidential corporate information. See Babbitt Inc. v. Lachner, 332 F.2d 255, 257 (2d Cir. 1964); Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 475 (9th Cir. 1961); Blau v. Lehman, 286 F.2d 786, 791 (2d Cir. 1960), aff'd 368 U.S. 403 (1962); Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir. 1943); Comment, 11 Stan. L.Rev. 358 (1959); Meeker & Cooney, 45 Va.L.Rev. 949, 951-52 (1959); Yourd, 38 Mich.L.Rev. 133, 145 (1939); 2 Loss, Securities Regulation 1041 (2d ed. 1961).

[7]See generally, 2 Loss, Securities Regulation 1123-24 (2d ed. 1961); 3 Loss, Securities Regulation, 1455-74 (2d ed. 1961); Yourd, 38 Mich. L.Rev. 133, 139-43 (1939).

firmed by legislative history,[8] and has been often remarked by the courts.[9]

The reasons which led Congress to declare insider profits on stock transactions forfeit only when purchase and sale both occurred within less than six months, though not spelled out in the legislative materials, are nonetheless clear. Improper use of inside information by corporate insiders is most likely to occur in short-term, in-and-out trading. The temptation to trade upon inside information is enhanced when the period for which capital must be committed is short. And ordinarily the useful life of "confidential" inside information is brief.[10] The evidence upon which Congress acted indicated that the abuse occurred almost entirely in short-swing transactions. Moreover, few if any reasons could be advanced for encouraging such trading by insiders. On the other hand, in long-term investment the risk of abuse of inside information was relatively slight, and the affirmative value of long-term personal financial commitments by insiders to the prosperity of the com-

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[8]See particularly, Stock Exchange Practices, Hearings before the Senate Committee on Banking and Currency, 73rd Cong., 1st Sess., pt. 15 at 6557-58 (1934).

[9]Babbitt Inc. v. Lachner, 332 F.2d 255, 257-58 (2d Cir. 1964); Kornfeld v. Eaton, 327 F.2d 263, 264-65 (2d Cir. 1964); Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 475 (9th Cir. 1961); Blau v. Lehman, 286 F.2d 786, 792 (2d Cir. 1960), aff'd 368 U.S. 403 (1962); Ferraiolo v. Newman, 259 F.2d 342, 344 (6th Cir. 1958); Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir. 1954); Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949).

[10]As the Commission has pointed out, "In and out trading greatly magnifies the possibility of profit from inside information in relation to a given amount of capital and makes such profit [all] the more unfair because of the relatively risk-free character of a short-term commitment which the insider may make in anticipation of a favorable market development." Securities Exchange Act Release No. 4509 (1950), CCH Fed. Sec. L. Rep. '48-'52 Decision, par. 76080.

panies which they controlled was obviously great. Thus, by basing forfeiture of profits upon the length of the insider's investment commitment, Congress sought to minimize misuse of confidential information, without unduly discouraging bona fide long-term investment.[11]

Appellees' investment commitment in Max Factor & Co. was a long term one, undertaken, as we have noted, many years prior to their exchange of Common for Class A. The exchange of Class A for Common did not interrupt the continuity of appellees' investment: it did not increase or decrease the amount invested, or alter in any way the risk assumed long years before. Moreover, since there was no speculative advantage in holding Class A rather than Common, the exchange conferred no opportunity for speculative profit which appellees did not already enjoy. Thus, appellees made only one investment decision in the six months' period—the decision to terminate their long-term investment by sale.[12] The exchange was in reality only a step in the process of sale—and an unnecessary one at that, for Common was as marketable as Class A and at precisely the same price.[13]

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[11]Securities Exchange Act Release No. 4509 (1950), CCH Fed. Sec. L. Rep. '48-'52 Decisions, par. 76080, quoted in part in Kornfeld v. Eaton, 217 F.Supp. 671, 767-77 (S.D.N.Y. 1963); Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir. 1954); Steinberg v. Sharpe, 95 F.Supp. 32, 34 (S.D.N.Y. 1950), aff'd on opinion below 190 F.2d 82 (2d Cir. 1951); Truncale v. Blumberg, 88 F.Supp. 677, 679 (S.D.N.Y. 1950), aff'd on opinion below, sub nom. Truncale v. Scully, 182 F.2d 1021 (2d Cir. 1950); Note, 63 Colum.L.Rev. 1518, 1521 (1963); Meeker & Cooney, 45 Va. L.Rev. 949, 963-64 (1959); Comment, 59 Yale L.J. 510, 511 (1950); Hardee, 65 Harv.L.Rev. 997, 1007 (1952).

[12]Cf. Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954).

[13]Class A was registered or "listed" on a national exchange under the Securities Exchange Act of 1934, and Common was not, but all shares of Class A issuable for exchange for out-

Thus, the making of the exchange, and its timing, were simply irrelevant to the use of insider information in short-term speculation—the problem with which section 16(b) is concerned. If appellees acted upon inside information in disposing of their stock interest when they did, the exchange was unrelated to that fact—they could have done so quite as well, at exactly the same time, realizing precisely the same profit, without converting their Common to Class A at all. So also the nature, duration ,and amount of their investment, the temptation and opportunity to trade on inside information, and the profit to be had by doing so, would all have been the same had the exchange been accomplished six months or more before the sale. In these circumstances, to hold that the exchange of Common for Class A constituted a "purchase" within section 16(b) would ignore the distinction which Congress drew between long-term investment and short-term speculation.

Appellant places primary reliance upon *Park & Tilford v. Schulte,* 160 F.2d 984 (2d Cir. 1947). While the broad language of the opinion in that case would

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standing shares of Common were also registered on the national securities exchange for listing on notice of issuance. Since there was an unrestricted right to exchange Common for Class A share for share at any time, and the latter would automatically be listed on the national securities exchange as soon as issued, Common and Class A were equally marketable. The evidence was undisputed that brokers accepted Common for sale at the market price for Class A, completing the exchange before delivery to the purchaser.

When appellees exchanged their Common for Class A, neither were registered (or exempt) under the Securities Act of 1933, and since appellees occupied a "control" relationship to the company, they could not transfer stock of either class to the general public without registering it under the 1933 Act. Since they exchanged their Common for Class A before making a public sale they registered only the Class A, but they might have registered the Common as readily.

support a decision that the appellees' exchange of Common for Class A constituted a section 16(b) "purchase,"[14] the holding does not. The preferred and common exchanged in *Park & Tilford* involved significantly different investment risks. For this and other reasons, the decision to exchange the convertible security required an investment decision within the six months' period distinct from the decision to sell the converted security—a new investment risk was undertaken, and a new, if limited, opportunity was presented to realize profit, or avoid loss, through the use of insider information.[15]

Affirmed.

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[14]Thus the court stated, "Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock within the meaning of the Act." 160 F.2d at 987.

[15]Laufer, 8 N.Y.L.F. 232, 243 (1962); Note, 107 U.Pa.L.Rev. 719, 725 n.30 (1959); Note 45 Va.L.Rev. 123, 126 n.19 (1959); Meeker & Cooney, 45 Va.L.Rev. 949, 962-963 (1959); Comment, 59 Yale L.J. 510, 526 (1950). But see Comment 11, Stan.L.Rev. 358, 361-65 (1959).

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IN THE

Supreme Court of the United States

October Term, 1965
No. 140

ISADORE BLAU,

Petitioner,

vs.

DAVIS FACTOR; LOUIS FACTOR; MAX FACTOR, JR., SIDNEY FACTOR; CHESTER FIRESTEIN; MAX FIRESTEIN; FREDA F. SHORE; ANNA FACTOR; DORIS FACTOR; DOROTHY FACTOR; CECILIA FIRESTEIN, and MAX FACTOR & CO.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Brief for Respondent, Max Factor & Co., In Opposition.

Statement of the Case.

This case is on Petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit, rendered February 24, 1965, which affirmed the judgment of the United States District Court for the Southern District of California, Central Division [R. 143], dismissing the complaints and cross-complaint against the individual respondents herein. The District Court did not render any opinion in

the action. Its Findings of Fact and Conclusions of Law [R. 137] were not officially reported. The opinion of the Court of Appeals for the Ninth Circuit [R. 155, Appendix of Petition, p. 3] is reported at 342 F. 2d 304.

Max Factor & Co. (the "Company") filed its complaint in the court below [No. 63-414 TC; R. 1] on April 8, 1963, in strict compliance with the demand made by petitioner Blau under date of March 5, 1963 [R. 9] for the purpose of obtaining (1) a judicial determination as to whether the transactions referred to in Blau's demand gave rise to any liability under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78p(b), and if so, (2) to recover the profits, if any, realized by certain of the individual respondents within six months from any purchase and sale of equity securities of the Company within the purpose and meaning of Section 16(b).

The District Court correctly determined [R. 140], among other things, that:

> (a) The individual respondents' exchanges of Common for Class A shares of the Company did not constitute "purchases" within the purpose and meaning of Section 16(b); and that
>
> (b) The individual respondents "did not, within the purpose and meaning of Section 16(b) of the Securities and Exchange Act of 1934, 'realize' any profit from any 'purchase and sale' of any stock of Max Factor & Co. within any period of less than six months by reason of the exchanges by them of Common Shares for Class A shares, followed by the sale of Class A Shares."

The decision of the United States Court of Appeals for the Ninth Circuit, in affirming the judgment of the District Court, upheld the foregoing determinations.

Points of Fact and Law Presented.

Reference is made to the Brief in Opposition to the Petition for Writ of Certiorari filed herein on behalf of the individual respondents for a statement of the material facts, pleadings and points of law involved, and citation of authorities and statutes.

Conclusion.

For the reasons asserted, and on the basis of the arguments advanced, on behalf of the individual respondents in their brief in opposition, it is the position of the Company that there are no special or important reasons warranting certiorari; that the decision below of the Ninth Circuit is not in conflict with the decision of any other court of appeals on the same matter nor is it in conflict at all with the Congressional purpose and intent underlying the enactment of Section 16(b); and that the decision below was entirely correct.

Respectfully submitted,

OVERTON, LYMAN & PRINCE,

CARL J. SCHUCK,

WAYNE H. KNIGHT,

Counsel for Respondent,
Max Factor & Co.